



June 21, 2004

The Honorable Mayor and
Members of the City Council:

I am pleased to submit to you the 2003 Comprehensive Annual Financial Report (CAFR) of the City of Seattle, Washington. The Department of Executive Administration has prepared this report to present the financial position of the City of Seattle on December 31, 2003, and the results of its operations and the cash flows of its proprietary fund types and changes in plan net assets of its pension and private-purpose trust funds for the year then ended. The financial statements and supporting schedules have been prepared in accordance with generally accepted accounting principles and meet the requirements of the State Auditor and the City Charter.

Washington State law requires an annual audit of the City's financial statements by the independently elected State Auditor. The State Auditor conducts his examination in accordance with generally accepted auditing standards and provides an independent assessment that helps assure fair presentation of the City's financial position and results of operations and the cash flows of its proprietary fund types and changes in plan net assets of its pension and private-purpose trust funds. In addition to the opinion on the City's financial statements included in this report, the State Auditor also issues separate reports on internal control and compliance with laws and regulations that meet the requirements of the Single Audit Act and related OMB Circular A-133. These reports are available in the City's separately issued Single Audit Report.

The accuracy of the City's financial statements and the completeness and fairness of their presentation is the responsibility of City management. The City maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded against loss or unauthorized use and that financial records can be relied upon to produce financial statements in accordance with generally accepted accounting principles. The concept of reasonable assurance recognizes that the cost of maintaining the system of internal accounting controls should not exceed benefits likely to be derived. Comprehensive written policies support the system and the Office of City Auditor reviews internal accounting controls based upon request or observed need.

This is the second year the City prepared the CAFR using the new financial reporting requirements as prescribed by the GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. This new GASB statement requires that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of a Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the report of the independent auditor.

Profile of the Government

The City of Seattle was incorporated on December 2, 1869. The City operates under a City Charter adopted on March 12, 1946, providing for a nonpartisan Mayor-Council form of government. The City Council is composed of nine members elected at large to four-year terms. The City provides the full range of municipal services authorized by its charter and operates four rate-funded utilities.

The City of Seattle is a primary government for financial reporting purposes. Its governing body is elected by the citizens in a general, popular election. This report includes all organizations and activities for which elected City officials exercise financial accountability. Certain organizations created by or related to the City, for which the City is not financially accountable, have been excluded from this report. Joint ventures and contingent liabilities, which exist from relationships with organizations created by the City, are included in this report. The notes to the financial statements further discuss the City as a financial reporting entity.

The City provides a full range of services, including the City's infrastructure services. The City builds and repairs roads, maintains electric, water, solid waste, sewer and drainage services, provides police and fire protection as well as judicial services, administers land use policy and takes an active role in commercial and industrial development and environmental protection. The City designs and maintains many parks and golf courses, coordinates recreation activities, maintains libraries, fosters neighborhood livability, and works to preserve a satisfactory living environment for both the community and individuals.

Budgets and Budgetary Accounting

The City Council approves the City's operating budget. In addition, the City Council annually approves two separate but related financial planning documents: the Capital Improvement Program (CIP) plan and the Community Development Block Grant (CDBG) program allocation.

The operating budget is proposed by the Mayor and adopted by the City Council at least 30 days before the beginning of the fiscal year. The budget is designed to allocate available resources on a biennial basis among the City's public services and programs and provides for associated financing decisions. On a biennial basis, the annual budget is adopted and the following year's budget is endorsed. The budget appropriates fiscal year expenditures and establishes employee positions by department and fund except for project-oriented, multi-year appropriations made for capital projects, grants, or endowments.

The CIP plan is also proposed by the Mayor and adopted by the City Council at least 30 days before the beginning of the fiscal year. The CIP is a six-year plan for capital project expenditures and anticipated financing by fund source. It is revised and extended annually. The City Council adopts the CIP as a planning document but does not appropriate the multi-year expenditures identified in the CIP. These expenditures are legally authorized through the annual operating budget or by specific project ordinances during the year.

The CDBG planning process allocates the annual grant awarded by the federal government. Allocations are made to City departments and non-City organizations. Legal authority is established each year by a separate appropriation ordinance for the Housing and Community Development Revenue Sharing Fund.

The control imposed by the City's adopted budget is maintained through the integration of budgetary accounts in fund ledgers for all budgeted funds. An encumbrance system accounts for purchase orders and other contractual commitments.

Factors Affecting Financial Condition

The U.S. economy boomed in the final years of the 1990s, driven by a soaring stock market and strong productivity growth. However, in early 2000 the stock market bubble began to deflate and the economy started to slow. The record ten-year expansion of the 1990s came to an end in March 2001 with the onset of the 2001 recession. The weakened economy was struck another blow by the terrorist attacks of September 11.

The national recession proved to be a mild one. Its impacts were mitigated by aggressive interest rate cuts by the Federal Reserve, federal tax cuts and tax rebates, and federal spending increases. Consumer spending slowed but did not turn negative as is typical during a recession, and the housing market was buoyed by low interest rates.

The recovery from the 2001 recession has been disappointing thus far. Corporate finance and governance scandals at firms such as Enron and World Com hindered the recovery during 2002, and the Iraq War dampened the pace of economic growth in early 2003. The national economy began to show signs of improvement in mid-2003 following a surge of home refinancing activity in spring 2003 and the passage of a package of federal tax cuts in May.

Gross Domestic Product (GDP) grew at an 8.2 percent rate in the third quarter of 2003 followed by 4.1 percent growth in fourth quarter. However, despite the upturn in GDP growth, job growth continued to disappoint. As of April 2004, 28 months after the end of the recession, U.S. employment was down by a quarter million jobs from the recession's end.

With its specialization in high tech business and flourishing dotcom sector, the Puget Sound region was hit hard by the 2001 recession. The September 11 attacks further slowed the region's economy and damaged businesses that are dependent on travel and tourism. Air travel dropped sharply and the world's airlines began losing large amounts of money, which led Boeing to sharply reduce its production of airliners and reduce its local workforce. As of April 2004 Boeing had cut 26,800 Puget Sound Region jobs since September 11, 2001.

After peaking in the fourth quarter of 2000 the four-county Puget Sound region experienced 11 successive quarters of declining employment. During that period the region lost 82,200 jobs, a drop of 4.7 percent. In fourth quarter 2003 the region finally experienced an increase in employment, albeit a very modest 0.3 percent gain.

Economic outlook

Most forecasters expect the national economy to continue to improve through the rest of 2004 and then grow at a moderate pace in 2005 and 2006. Employment growth is expected to move into the 2-percent range beginning in 2005, and GDP growth is forecast to increase by 3 percent to 4 percent per year. However, there is some concern that growth may weaken when the effects of the federal tax cuts and low interest rates wear off.

The region is expected to lag the nation in recovery largely because the local recession has been much more severe than the national recession. Boeing continues to reduce its employment, although the number of layoffs during recent months has been far lower than in the months immediately following the September 11 attacks.

Puget Sound Region employment is forecast to increase by 1 percent in 2004 and then grow at a 2-percent rate in 2005 and 2006. At this pace the region's employment will not return to the level reached in

2000 until 2006. Boeing employment is forecast to remain relatively stable for several years and then increase later in the decade as the market for commercial airliners improves. Microsoft is expected to continue to expand. The greatest risk to the region's economy is a slowdown in the national economy.

MAJOR INITIATIVES

2004 Budget: 2004 is the second year of the 2003-2004 biennial budget. In August 2003 the forecast for 2004 General Fund revenues were about \$15 million lower than had been estimated when the 2004 budget was endorsed in November 2002. This shortfall was covered through a combination of lower-than-expected inflation in expenditures and cuts in many departments. The Mayor and City Council continued their commitment to maintaining core City services, so the budget cuts did not affect uniformed Police or Fire staffing, human service safety net programs, or Library hours.

Streetlights: In November 2003 the State Supreme Court ruled that the City's practice of having Seattle City Light pay for streetlights through utility rates was unconstitutional. This required the City's General Fund to assume about \$6 million of annual expenses for streetlights. This change in funding source was made the day after the Court's ruling. In addition, it is possible that the courts will order refunds of money paid by City Light for streetlights over about a four-year period. The City has proposed that the courts allow the General Fund to repay the Light Fund over four years. This would cost the General Fund about \$6 million annually, in addition to the \$6 million ongoing operating expense.

In March 2004 the Mayor and City Council agreed to a revised 2004 General Fund budget that incorporates this \$12 million of annual streetlight-related expense. Additional budget reductions were made in many departments, but core services were protected as before. Court action on the possible streetlight refund and related issues will continue in 2004 and appeals are not likely to be resolved until 2005.

Fire Facilities and Emergency Response Program: In November 2003 the City's voters approved a nine-year \$167 million property tax levy lid lift to replace or remodel almost all of the City's fire stations, build a new Emergency Operations Center and Fire Alarm Center, develop a Joint Training Facility, replace or refurbish the City's fire boats, and purchase or build a variety of emergency response equipment and facilities. The ballot measure passed with a 67 percent "yes" vote. The highest priority projects will begin design and construction in 2004. The City is using a variety of other funds to supplement the levy, including the Cumulative Reserve Subfund and money from the federal government and the Port of Seattle for fireboats.

Civic Center: Seattle's new Civic Center neared completion in 2003. The new Justice Center housing the Seattle Police Department and Seattle Municipal Court opened in the fall of 2002. The new City Hall opened in the summer of 2003. Work continues to move City offices into Key Tower and to build the City Hall plaza on the site of the old Municipal Building. These projects are expected to be completed in 2004.

Remodeling of the Park 90/5 complex is expected to be completed in the summer of 2004. These buildings will house the "back office" functions of the Police Department, including evidence storage and training functions. These units will then move out of the old Public Safety Building and demolition of that building likely will begin in the fall.

McCaw Hall: The existing Opera House at Seattle Center was remodeled into the Marion Oliver McCaw Hall and reopened in June 2003. The new facility eliminates the seismic weaknesses of the old building and provides much better acoustics, seating, lighting, and performance support spaces. The new building

has been widely praised by architecture and music critics. The remodeling was funded using a mix of public and private funds, including funding from a City property tax levy lid lift.

Other City Capital Projects: The Seattle Public Library continued to develop a variety of projects funded from the Libraries for All bonds in 2003. The new Central Library opened in May 2004. Several new or refurbished branch libraries are also scheduled for completion in 2004. The Parks Department continues to develop new or expanded community centers and other facilities using funds from two voter-approved levy lid lifts. These funding sources also have paid for the purchase of additional open space throughout the City.

Urban Area Security Initiative: The City of Seattle received a significant amount of federal funding under the Urban Area Security Initiative (UASI). Two different allocations, one directly to the City and one shared with other governments in the region, provided a total of \$19.98 million for Seattle in 2003. Most of these funds will be devoted to equipment and training for the Police and Fire departments. Additional funds will be used to improve the security of the City's technology and to support emergency preparedness for the utilities.

Bond Issues: The City continued to take advantage of low-interest rates to finance new projects and to refund older bonds to capture interest rate savings. In February the City sold \$60.9 million of Limited Tax General Obligation (LTGO) bonds for a variety of new capital projects and to refund a portion of the 1994 bonds that were originally issued on a taxable basis. The true interest cost on the bonds was 3.474 percent. The City's LTGO bond ratings were reaffirmed by all three rating agencies: Fitch Ratings (AA+), Moody's Investors Service (Aa1), and Standard & Poor's (AAA).

In April, Seattle Public Utilities sold \$271.3 million of revenue bonds for the Water Fund, with about 62 percent of the proceeds being used to refund 1993 bonds. The refunding saved \$13.8 million in debt service. In July, Seattle City Light sold \$256.8 million of revenue bonds, with about 47 percent of the proceeds being used to refund 1993 bonds. The refunding saved about \$6.5 million in debt service. The utilities' bond ratings were also reaffirmed.

Cash Management

The Treasury Services Unit of the Department of Executive Administration, administers all cash-related transactions for the City of Seattle. City cash (exclusive of pension fund cash administered by the Seattle City Employees' Retirement System and some debt refinancing proceeds administered by trustees) is deposited into a single concentration banking account.

Investments of temporarily idle cash are made according to City Council-mandated policies in U.S. Treasury and agency issues, certificates of deposit and other investment deposits issued by Washington State depositories that qualify under the Washington State Deposit Protection Act as defined by RCW 39.58, bankers' acceptances sold on the secondary market, commercial paper purchased in the secondary market, repurchase and reverse repurchase transactions, the public funds investment account known as the Local Government Investment Pool (LGIP) in the State Treasury, and other securities as authorized by law. The City is allowed to engage in securities lending transactions, the fees for which are credited to the investment income account. City policies require the City to minimize market risks by safekeeping all purchased securities according to governmental standards for public institutions, to maintain liquidity by restricting the City's total investment portfolio to an average life of no more than five years, and to consider social goals in the placement of investments. A report on the performance of the investment program in meeting these policies is prepared monthly for review by the Director of Finance and the Director of Executive Administration and forwarded to the City Council's Finance and Budget Committee.

The market value of investments held in the pooled and dedicated funds' combined portfolio under the direct supervision of the Treasury Services Unit as of December 31, 2003, was \$660.9 million with earnings of \$24.0 million and a return on investment of 3.024 percent.

Risk Management

In 2003 the City purchased excess insurance policies to address general, professional, public official and other liabilities; and all risk property coverage including earthquake and flood, with boiler and machinery, builders risk, and electronic data processing endorsements. Insurance was also purchased for fiduciary and crime liability, contractors' equipment, transportation, inland marine, fine arts, railroad protective liability, and an assortment of commercial general liability, medical, accidental death and dismemberment, and miscellaneous policies. Bonds were purchased for public officials, notary public, and pension exposures.

Pension Trust Fund Operations

The operation of the Seattle City Employees' Retirement System resulted in a net total investment return of 23.6 percent, up from a negative net total return of 8.4 percent in 2002. Rebounding financial markets in the U.S. and abroad impacted the system's investments and resulted in a net gain in value of \$291.0 million. The total net assets held at the end of 2003 is \$1.528 billion, an increase of \$272.8 million from 2002. As of January 2002 the actuarial valuation showed a \$197.7 million actuarial accrued liability.

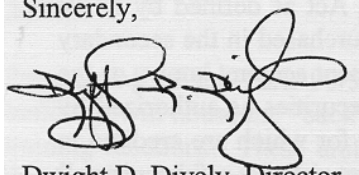
Additional information on the City of Seattle's Pension Plans can be found in Note 10 in the notes to the financial statements.

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Seattle for its comprehensive annual financial report for the fiscal year ended December 31, 2002. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

I would like to express my appreciation to the entire staff of Accounting Services, other members of the Department of Executive Administration, and other City departments who contributed to the preparation of this report. Finally, I thank you for your interest and continuing support in planning and conducting the City's financial operations in a responsible manner.

Sincerely,



Dwight D. Dively, Director
Department of Finance